Internal Revenue Service

memorandum

CC:INTL:Br2 - INTL-892-87
BFelker

date: DEC 31 1987

to: Ron Bosze

from: Phyllis Marcus, Chief, Branch 2, Office of the Associate Chief Counsel (International)

subject: [redacted]: Effect of NOL Carryback on §902 Deemed Paid Credit

Facts

We understand that [redacted] ([redacted]) paid dividends to its U.S. parent, [redacted], in [redacted], [redacted], [redacted], and [redacted] out of accumulated profits for the taxable years [redacted] through [redacted]. [redacted] paid West German taxes on its profits for the taxable years [redacted] through [redacted]. With some exceptions, [redacted] incurred E&P deficits for the taxable years [redacted] through [redacted]. At [redacted], [redacted] had a cumulative E&P deficit after dividends.

You requested our views as to whether E&P deficits incurred by [redacted] for tax years after [redacted] can be used to offset accumulated profits for the tax years [redacted]-[redacted] for purposes of computing the denominator of the section 902 credit fraction with respect to dividends paid in [redacted]-[redacted]. The German taxes for [redacted]-[redacted] were not adjusted by reason of the NOLs. All years are open in competent authority proceedings. For discussion purposes, assume the following simplified facts:

	E&P	Distribution	Tax	FTC
year 1	100	0	30	0
year 2	100	50	40	20
year 3	(75)	0	10	0

The taxpayer proposes to carry back the NOL to eliminate undistributed accumulated profits and then to recompute the section 902 credit for open years in which dividends were paid. In the example above, the taxpayer

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would apply 50 of the (75) NOL from year 3 to eliminate the undistributed E&P (100 E&P - 50 dividend) in year 2. The taxpayer would then recompute the section 902 credit to pull up 100% of the foreign taxes paid in year 2: (50 dividend/50 accumulated profits) x 40 tax = 40 credit.

Applying the carryback to post-distribution accumulated profits operates to increase the section 902 credit, because the numerator of the 902 fraction (dividends paid) will remain unchanged while the denominator (accumulated profits) is reduced. The taxpayer argues that the rationale of Champion International Corp. v. Comm., 81 T.C. 424 (1984), acq., 1984-2 C.B. 1, and Rev. Rul. 87-72, 1987-31 I.R.B. 8, supports its position. We disagree.

In our view, no recomputation of the 902 credit is appropriate on these facts. While neither Rev. Rul. 87-72 nor the Champion decision dealt with the application of an NOL carryback to a year in which a distribution was made, we agree with the taxpayer that the (75) NOL should be carried back to reduce accumulated profits by 50 in year 2 and by 25 in year 3. Therefore, after taking into account the distribution in year 2 and the NOL in year 3, the taxpayer has 75 of accumulated profits available for distribution from year 1 if distributions in future years exceed current E&P. However, in our view the carryback is made only for the purpose of determining the source of future distributions and the amount of creditable taxes with respect to such future distributions. At least in the absence of a foreign tax refund, the creditable taxes on the year 2 dividend should remain at 20: (50 dividend/100 year 2 accumulated profits) x 40 tax = 20 credit.

Contrary to the taxpayer's assertion, the failure to recompute the credit does not result in double taxation. Because only half of the current earnings were distributed in year 2, only half of the taxes should be creditable. Since the U.S. will never impose tax on undistributed earnings eliminated by the NOL, no credit should be allowable for foreign taxes paid on those earnings. Therefore, the 20 of taxes paid on year 2 profits that are eliminated by the NOL will never be creditable. This potential loss of tax credits was inherent in the statutory scheme in effect for years prior to 1987, which required an annual computation of accumulated profits. See Rev. Rul. 87-72, Situation 2. In adopting new rules to pool earnings and taxes for credit purposes for post-1986 taxable years, Congress recognized this defect in the old statutory scheme. However, pooling was not in effect for the taxable years in issue here. The annual computation of accumulated profits then required under section 902 precludes the recomputation advanced by the taxpayer.

Moreover, neither the taxpayer's approach nor any other formula for applying NOL carrybacks for 902 purposes will prevent over- or under-crediting in all cases.

In this case, we believe the taxpayer's approach, by reducing the credit fraction to 1/1, would inflate the potential foreign tax credit to include foreign taxes paid on earnings not subject to U.S. taxation. Therefore, the original credit calculation made at the time of the distributions properly reflects the foreign taxes deemed paid on the dividends and should not be disturbed. If you have further questions on this issue, please call Barbara Felker at (202) 634-5406.